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In the Supreme Court of the United States

OCTOBER TERM, 1965

UNITED STATES OF AMERICA, *Petitioner*

vs.

W. H. WARDLAW, *Independent Executor of the Estate of C. W. Wardlaw, Deceased, et al.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENTS W. H. WARDLAW, INDEPENDENT EXECUTOR OF THE ESTATE OF C. W. WARDLAW, DECEASED, ET AL.

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OPINIONS BELOW

The District Court did not file an opinion. Its findings of fact and conclusions of law in **Wardlaw,**[1] et al

1—The Respondents in the case of United States of America vs Wardlaw, Independent Executor of the Estate of C. W. Wardlaw, Deceased, et al, are as follows:

W. H. Wardlaw, Independent Executor
of the Estate of C. W. Wardlaw, Deceased
W. H. Wardlaw
W. R. Whitehead
F. H. Whitehead
L. D. Whitehead
F. J. Barrett
W. R. Hodge
B. E. Wilson

These Respondents commenced this proceeding in Civil Actions Nos. 306-307, 328-333, respectively, against the United States in the United States District Court for the Western District of Texas, Del Rio Division. These cases were consolidated by the United States in No. 21,607, United States of America, Appellant, vs. W. H. Wardlaw, et al, Appellee, in the United States Court of Appeals for the Fifth Circuit. These cases were then consolidated by the Petitioner with No. 21351, United States of America, Appellant, vs. John Catto, Jr. and Roxana Catto, Appellees, in the United States Court of Appeals for the Fifth Circuit, in the Petition for Writ of Certiorari.

(R. 50-64) are reported at 223 F. Supp. 631, and the opinion of the Court of Appeals (R. 104-106) is reported at 344 F.2d 225.

JURISDICTION

The judgment of the Court of Appeals was entered on April 8, 1965 (R. 107-108). The time for filing a petition for a writ of certiorari was extended to and including September 5, 1965 (R. 109 and 111). The petition for a writ of certiorari was filed on September 3, 1965, and granted on November 22, 1965 (R. 112). This Court has jurisdiction under 28 U.S.C. 1255 (1).

QUESTIONS PRESENTED

The Respondents in the **Wardlaw** case, who selected the accrual method of accounting many years before the Commissioner in 1944 acknowledged that breeding animals qualified for capital gains treatment under Section 117 (j), as "property used in the trade or business", and who were compelled by Reg. 111, Sec. 29.22 (c)-6, as amended by T.D. 5423, to use the unit-livestock-price method of valuing their livestock inventory, and were required by the Commissioner's construction of Reg. 1.471-6 (f), and its predecessors, to include their raised breeding animals in inventory, contend that they have a right to remove these raised breeding animals from inventory, and that they have no duty to capitalize the cost of feeding and raising their raised breeding animals but may deduct such raising costs as a current expense, as expressly permitted by Reg. 1.162-12, and its predecessors.

The questions presented in the **Wardlaw** case are:

(1) Can the Commissioner, without statute or regulation to support him, and in the face of express language to the contrary in his own longstanding Reg. 1.161-12, which by the process of statutory re-enactment has, he admits, attained the force of law, refuse to permit an accrual method farmer to expense his raising costs and force him to capitalize them instead?

(2) If the Commissioner cannot do this, can he, nevertheless, require the farmers in the **Wardlaw** case to keep their raised breeding animals in inventory and thereby, indirectly, but effectively nevertheless, force them to capitalize their raising costs, something that Reg. 1.162-12 says he cannot do directly?

STATUTES AND REGULATIONS INVOLVED

In addition to the Statutes and Regulations involved, as stated in Petitioner's Brief (page 3), the following Statutes and Regulations are involved:

Revenue Act of 1942 c. 619, 56 Stat. 798 Section 151 (appearing at page 51, Appendix A)

Revenue Act of 1951 c. 521, 65 Stat. 452 Section 324 (appearing at page 52, Appendix A)

Treasury Regulation 111, Internal Revenue Code of 1939

Section 29.23 (a)-11

Section 29.22 (a)-7

Section 29.22 (c)-6

(appearing at pp. 53-5, Appendix A).

STATEMENT OF FACTS

The taxpayers in the **Wardlaw** case are ranchers engaged in the business of breeding and raising sheep, goats and cattle for the production of wool, mohair, mutton and calves. The taxpayers maintained breeding herds of sheep, goats and cattle for use in connection with their ranching business and, as circumstances required, they selected certain animals at birth from the breeding herd and added same to the breeding herd, the number of animals retained in the breeding herds being determined on the basis of range conditions, rainfall, cost of operation and other factors. Other animals, born on the farm and purchased, were held for sale to customer in the ordinary course of business.

When they commenced business (one of the taxpayers commenced his ranching business prior to 1913, one in 1917, three in 1927, two in 1935, and one in 1941 (R.54)), taxpayers adopted the accrual method of accounting and a constant unit price method of valuing their inventories. After the enactment in 1942 of Section 117 (j) of the Internal Revenue Code of 1939[2], Regulation 111, §29.22(c)-6 was promulgated[3] in 1944, providing that a livestock raiser who, prior to 1944, had adopted a constant unit price method of valuing his livestock inventories, and who had filed returns on this basis, was considered as having "elected" the

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2—Sub-Section (j) was added to Section 117 by Section 151(b) of the Revenue Act of 1942. c.619, 56 Stat. 798. It provided capital gains treatment for "property used in the trade or business" of a taxpayer. In 1944 the Commissioner conceded that this embraced livestock held for breeding purposes.

3—As amended by Treasury Decision 5423, 1945 Cum. Bull, 70, effective January 1, 1944, the present counterpart of which is Reg. 1.471-6.

"unit-livestock-price method"[4]; §29.22(c)-6 also provided that a taxpayer electing the unit-livestock-price method was required to include in his livestock inventory "all livestock raised, whether for sale or for draft, breeding, or dairy purposes"[5] As a result of being thus compelled by this Section of the Regulations to include their raised breeding animals in inventory, the taxpayers in the **Wardlaw** case were forced to include in their **ordinary income** the initial inventory values of their raised breeding animals and thereafter the annual increases in inventory values assigned to such animals, including the tax years, 1957-1959, inclusive, here involved,[6] (a) despite the fact that Section 117 (j) and its successor, Section 1231 of the Internal Revenue Code of 1954, plainly provided that gain from the sale of "property used in the trade or business" should be taxed as capital gain, (b) despite the fact that the taxpayers had no "meaningful choice"[7] as to ac-

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4—Reg. 111, Sec. 29.22(c)-6, as amended by T.D. 5423: "A livestock raiser who has, for taxable years beginning prior to January 1, 1944, adopted a constant unit price method of valuing livestock inventories and filed returns on that basis, will be considered as having elected the 'unit-livestock-price method'." This method provides for valuation of different classes of animals at a standard unit price for each animal within a class.

5—"Regs. 1.471-6(f) [the present counterpart of Sec. 29.22(c)-6] . . provides that a taxpayer who elects to use the unit-livestock-price method must apply it to all livestock raised including breeding animals. This means that a livestock raiser who uses this method cannot segregate his raised breeding herd and treat it as though it were a capital asset subject to depreciation . . ." United States v. Ekberg, 291 F(2) 913 at p. 917, fn. 5.

6—This result is admitted by the Government (Stip. 25, R. 72); the District Court found as a fact that the result of taxpayers being required by the Regulation to use the unit-livestock-price method and include raised breeding animals in inventory was that the initial inventory value of raised breeding animals put in inventory was taxed as ordinary income and all annual increases thereafter in inventory value of such raised breeding animals were also taxed as ordinary income. (Findings of Fact 11, R. 57).

7—As pointed out in the **Ekberg** case, a "meaningful choice" as to accounting methods and as to methods of valuing inventory was not possible until 1944, when it first became apparent, by reason of the issuance of I.T. 3666, 1944 CB 270, that capital gain was available on the sale of raised breeding animals, provided the rancher did not adopt the accrual method of accounting and the unit-livestock-price method of valuing his inventories.

counting method and no choice at all as to method of valuing their inventories, and (3) despite the fact that the net effect of this forced inclusion was to compel a capitalization of raising costs of breeders, specifically made deductible under Reg. 1.162-12 as a current expense.

The District Court held that the selection of the accrual method of accounting and the unit-livestock-price method of valuing inventory, by the taxpayers in the **Wardlaw** case, when they commenced operating their ranches, was not a meaningful choice inasmuch as the statute then did not authorize capital gains treatment on the sale of livestock used for breeding purposes.[8] (R. 62). The District Court also held that, under these circumstances, the Regulation requiring the inclusion of raised breeding animals in inventory was invalid as to the livestock farmers before the Court; that the requirement that raised breeding animals be included in inventory was in conflict with Section 1231 of the Internal Revenue Code; that Section 1231 of the Internal Revenue Code clearly and unequivocally stated that livestock held for breeding purposes is property used in the trade or business of the taxpayer[9], and as to such livestock taxpayers were not required to include them in inventory or to use the unit-livestock-price method to determine the cost basis of animals sold. (R. 61-62).

8—Actually, the taxpayers in the **Wardlaw** case selected a constant unit price method of valuing their inventory when they commenced business, but as noted above, Reg. 111, Sec. 29.22(c)-6 required that taxpayers using a constant unit price method prior to 1944 were forced to elect and use the unit-livestock-price method for years after 1944. Obviously, the selection of a constant unit price method was not a meaningful choice, because at the time of the selection (long prior to 1944) capital gains treatment for the sale of breeding stock was not authorized.

9—Section 117(j) of the Internal Revenue Code of 1939 was amended by Section 324 of the Revenue Act of 1951, c.521, 65 Stat. 452, to include within the definition of "property used in the trade or business" the present specific reference to "livestock, regardless of age, held by the taxpayer for draft, breeding or dairy purposes"; the 1951 amendment to Section 117(j) was by its terms made applicable to taxable years beginning after 1941.

The Court of Appeals for the Fifth Circuit, noting that the District Court had followed the opinion in **Scofield v. Lewis,** 251 F.2d 128, (C.C.A. 5th, 1958), and recognizing that such opinion was directly in point and was controlling, affirmed the judgment of the District Court with respect to the raised breeding animals.

SUMMARY OF ARGUMENT

Since the early days of the income tax, the Regulations have permitted livestock farmers to take current expense deductions for the cost of raising their livestock. This was the rule whether the livestock were being raised for sale or to serve as breeding animals, and whether the farmer was on the accrual or the cash method of accounting. The regulation has not changed materially over the years.[10] By successive reenactment of the statute under which this regulation was promulgated, the regulation attained the force and effect of law.

In 1942, Congress saw fit to extend capital gains tax treatment to "property used in the trade or business", even though the property was not by definition a capital asset. In 1944 the Commissioner of Internal Revenue published I.T. 3666, which ruled that breeding animals qualified as "property used in the trade or business," and hence capital gains treatment was available on their sale.

The inter-action of the regulation permitting livestock farmers to deduct the cost of raising their breeding animals as a current expense and the statute granting capital gains treatment on the sale of breeding

10—In 1921 the regulation stated that "the cost of feeding and raising livestock may be treated as an expense deduction. . ." Reg. 45, Art. 110. Today it states that "The purchase of feed and other costs connected with raising livestock may be treated as expense deductions. ..." Reg. 1.162-12.

animals created a problem, or at least the Commissioner considered it a problem. To permit the farmer to deduct the cost of raising a breeding animal as a current expense, and then allow him to receive capital gains treatment when the animal was sold was, to the Commissioner, a "distortion"[11] of taxable income and a "windfall"[12] to the farmer. To remedy, or at least alleviate, the situation, the Commissioner promptly sought to curb the application of the new capital gains treatment section by instituting a narrow-as-possible definition of what would constitute breeding animals "used in the trade or business." Congress, however, noting the "considerable confusion and dispute" brought on by the Commissioner's various rulings,[13] rejected these efforts in 1951 by amending Sec. 117(j) expressly to include "livestock, regardless of age, held by the taxpayer for breeding purposes. . ."

Meanwhile, the Commissioner had acknowledged, in I.T. 3666, that there was no way he could keep the cash method farmer from deducting the cost of raising his breeders as a current expense, as permitted by Reg. 1.162-12, or from receiving capital gains treatment upon the sale of his raised breeders, as provided by Sec. 117 (j). At the same time, the Commissioner decided he might have more success against livestock farmers who were on the accrual method of accounting and kept inventories. He realized there was no law or regulation requiring that all accrual method farmers should put their raised breeders in inventory.[14] However, his Regulation 111, Sec. 29.22(c)-6,

11—Letter from the Secretary of Treasury to the Chairman of the Senate Finance Committee, 1952, R. 9, at p. 11.

12—Brief, p. 15.

13—See Senate Report No. 781, 82d. Cong. 1st Sessions, 1951-2. Cum. Bull. 457, 487, fn. 24.

14—The general rule was that livestock raised or purchased **for sale** must be included in inventory, but that livestock acquired (by birth or by purchase) **for breeding purposes** might be included or excluded. Regs. 111, Sec. 29.22(a)-7, corresponding to the present Regs. 1.61-4(b). See also United States v. Ekberg, page 917, fn. 5.

as amended by Treasury Decision 5423 in 1944, seemed to say that any farmer using the unit-livestock-price method of valuing his inventory of animals held for sale must also include his **raised** breeding animals in inventory, and value them by the same method.[15] He therefore took this interpretation as his position, requiring all such farmers to report the initial value given to these raised breeders when they were thus forced into inventory as ordinary income, and to do likewise as to the annual increases in their inventory value thereafter. Since the inventory value given to these raised breeding animals under the unit-livestock-price method equaled (often exceeded) the cost of raising them, the net effect of the Commissioner's position was to force livestock farmers using this method of valuation to capitalize the cost of raising their breeders, as Petitioner admits, rather than deduct such cost as a current expense pursuant to Reg. 1.162-12. The breeding animal was normally kept by the farmer during its useful life, and then sold. In the case of sheep and goats, the selling price would generally not exceed the last inventory value given to the animal, so that the farmer would get no capital gains treatment at all on the sale of the raised breeding animal, since there would be no gain; as for cattle, the cow or bull would normally be sold at a gain, if the market was steady, but the bulk of the increase in value of the breeder, from birth to sale, would have already been taxed as ordinary income, leaving relatively little to be taxed as capital gain.

The **Lewis** case said that Reg. 111, Sec. 29.22-6, as thus construed by the Commissioner to **force** raised breeders into inventory, was invalid. The **Ekberg** case said the regulation was valid only if the taxpayer

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15—The corresponding regulation today is Reg. 1.471-6(f).

elected to use the accrual method of accounting and the unit-livestock-price method of valuing inventories with knowledge of the tax consequences of his election as to his raised breeding animals; and that he could not have had such knowledge if he had had to make his election prior to 1944, it having been recognized in that year, for the first time, by I.T. 3666, that capital gain was available on the sale of breeding animals.

In the **Wardlaw** case now before this Court, the farmer-taxpayers elected the accrual method of accounting many years before I.T. 3666. Consequently, their choice was not "meaningful." Furthermore, the farmers in the **Wardlaw** case **never elected** the unit-livestock-price method; **on the contrary, it was forced upon them** by the Regulations.[16]

Petitioner now says he was wrong in his contention, in the courts below, that Reg. 1.471-6(f), formerly Reg. 111, Sec. 29.22-6, requires that raised breeding animals be put in inventory. Instead, he makes the new contention that this regulation, while not requiring that raised breeders be put in inventory, does require that farmers who have chosen the unit-livestock-price method of valuation must capitalize the raising costs of their breeders anyway, presumably whether they have been included in inventory or not, and cannot expense these costs. Petitioner cites no authority for this new construction of Reg. 1.471-6(f), because, of course, there is none. However, there **is** ample authority to the effect that **the cost of raising breeders is properly deductible as a current expense;** this authority is the Commissioner's own 45-year old Regulation 1.162-12,

16—This was because these taxpayers, long prior to 1944, adopted a constant unit price method of valuing their livestock inventories, and under the amended regulations of December 1944, by Treasury Decision 5423, it was provided that any livestock raiser who, for years prior to 1944, had adopted a constant unit price method of valuing inventories would "be considered as having elected the 'unit-livestock-price' method."

and its predecessors. Moreover, if a particular item is a deductible expense for a livestock farmer on the cash method of accounting, as the Commissioner has acknowledged, it is also a deductible expense for a livestock raiser on the accrual method. The two methods differ as to **when** an item is expensed, but not as to **whether.**

This then is the issue before this Court: Can the Commissioner, without any authority except his latest construction of Reg. 1.471-6(f), and in the face of express language to the contrary in his own longstanding Reg. 1.161-12, which by the process of statutory re-enactment has, he admits,[17] attained the force of law, refuse to permit an accrual method farmer to expense his raising costs and force him to capitalize them instead? If the Commissioner cannot do this, can he, nevertheless, require the farmers in the **Wardlaw** case to keep their raised breeding animals in inventory and thereby, indirectly, but effectively nevertheless, force them to capitalize their raising costs, when Reg. 1.162-12 says that such costs are deductible as a current expense?

ARGUMENT

I

Since the early days of the income tax, all livestock farmers have been permitted, under what is now Reg. 1.162-12, to deduct the cost of raising their breeding animals as a current expense. This right cannot be denied by forcing raised breeding animals into inventory, or by requiring such costs to be capitalized.

A livestock farmer, like any other taxpayer, must choose his method of accounting when he first begins business. This is the only time he has a choice, and his

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17—Brief, p. 16.

choice is between the cash receipts and disbursements method and the accrual method. Once he makes a selection, he must stay with it for all subsequent years. The difference between these two methods of accounting is simply one of timing. The taxpayer on the cash method reports his income when he receives it, and deducts his expenses when he pays them; whereas the accrual method taxpayer deducts his expenses when they are incurred, even though not yet paid, and reports his income when it has accrued, even though it has not yet been received. A livestock farmer using the accrual method keeps an inventory of his livestock held for sale.[18] He computes his gross income by reference to his inventory at the opening of the taxable year and at the close of the taxable year. He does this by increasing the value of his inventory at the close of each year to reflect the increase in the value

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18—"A taxpayer's taxable income shall be computed upon the accounting method by which his books are kept. Sec. 446(a). Recognized and permitted general methods of accounting include the cash receipts and disbursements method, an accrual method, and combinations of these. Sec. 446(c). The cash receipts and disbursements method generally contemplates the inclusion of income for the year in which received and the allowance of deductions for the year in which paid. The accrual method generally relates income and deductions to the year in which earned or incurred. Regs. Sec. 1.446-1(c) (i) and (ii). A taxpayer filing his first return may adopt any permissible method of accounting. Regs. Sec. 1.446-1(e) (1). Once having chosen his method, however, the taxpayer, if he wishes to change it and before computing his taxable income under a new method must secure the consent of the Commissioner. Sec. 446(e) and Regs. Sec. 1.446-1(e) (2).

"A farmer—and this includes a rancher such as the taxpayer here, Regs. Sec. 1.61-4(d)—has, as does any other taxpayer, the same initial choice of accounting method. He may use the cash receipts and disbursements method or he may use an accrual method. Having elected one method, he must stay with it for subsequent years unless authorized by the Commissioner to change his method. Regs. Sec. 1.471-6(a). If, however, he uses the accrual method then he must use inventories to determine his gross income. Livestock raised or purchased for sale **shall be** included in the inventory at their proper valuation, and livestock acquired for draft, breeding, or dairy purposes and not for sale **may be** included in the inventory . . . instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently from year to year by the taxpayer. Regs. Sec. 1.61-4(b)." (Emphasis added.) See United States v. Ekberg, pp. 916-17, fn. 5.

of his livestock on account of their getting older and larger and therefore presumably having a higher market value. Long before the Regulations, in 1944, expressly and for the first time authorized the "farm-price method" and the "unit-livestock-price method" of valuing livestock inventories,[19] many livestock farmers, instead of putting their livestock in inventory at cost, or at cost or market whichever was lower, followed the practice of giving all their livestock a fixed unit value based on age, type of animal, and sex. Thus a one-year old cow, a yearling heifer, would be given a certain value, a two-year old cow a greater value, etc. The same would be done for sheep, for goats, and other farm animals. This was known as a "constant unit" method of valuation, and, as indicated, it was practiced by livestock farmers long before the advent, in 1944, of the Regulation authorizing the farm-price method and the unit-livestock-price method. By using this "constant unit" method, the livestock farmer created taxable income before he actually realized it, for as soon as the animal was put into inventory at a unit value, ordinary income resulted; and as the inventory value increased with the aging of the animal, additional income was created. In the early days of taxation, this was helpful, because the farmer could, in this manner, create income to offset against the deductible expenses incurred in feeding and caring for his livestock. Today, however, there is no particular advantage in doing this because of the statutory right to carry operating losses forward and offset them against income of a later year.[20]

Long before the advent of the regulation which

19—The unit-livestock-price method provides for valuation of different classes of animals at a standard unit price for each animal within a class. The farm-price method was an alternative method whereby animals in inventory were valued according to their current market value less cost of marketing.

20—This statutory right first appeared in the Revenue Code adopted by Congress in 1939.

has helped to give rise to the present controversy, namely, Reg. 1.471-6 (f), and its predecessor, livestock farmers followed the practice of including their raised breeding animals in inventory along with their animals held for sale to customers in the ordinary course of business. This was done as a matter of convenience, and because there was no difference in the tax treatment of the profit on the sale of breeding animals as distinguished from the profit on animals held for sale to customers. In both instances the profit was taxable as ordinary income. There was no law or regulation requiring that raised breeding animals either be included in inventory or excluded, and there was no suggestion that Congress would, in 1942, expressly extend capital gains treatment to livestock held for breeding purposes. The cash method farmer and the accrual method farmer were treated just alike, tax-wise, both on the sale of animals held for breeding purposes and animals held for sale to customers, the only difference being the timing of the tax: for the cash method farmer there would be no tax until he sold the animal, but for the accrual method farmer profit on the animal would be anticipated by using inventories, and the tax would therefore be paid before profit was in fact realized. However, in both instances the profit would be taxed as ordinary income, and until 1942 there was no suggestion that profit from the sale of breeding animals would be taxed as capital gain.

In 1942 Congress extended the privilege of capital gains treatment to the sale of certain assets theretofore expressly excluded from the statutory definition of "capital assets". Section 117 (a) of the Internal Revenue Code of 1939 gave the same broad general definition to "capital assets" as does the present Section 1221, and then excluded from that definition, as does Section 1221, stock in trade, inventory prop-

erty, property held primarily for sale to customers in the ordinary course of business, and property used in the trade or business subject to the depreciation allowance. There was nothing in the 1939 Code, as originally enacted, which corresponded to the present Section 1231 of the 1954 Code granting capital gains treatment to property used in the trade or business. The predecessor to Section 1231 was Section 117 (j) of the amended 1939 Code; it appeared originally in the Revenue Act of 1942. This new section defined "property used in the trade or business" to be property so used which was subject to the depreciation allowance[21] and held for more than six months, and which was not inventory property or property held primarily for sale. This new section extended the benefits of capital gains treatment to property falling within this definition of "property used in the trade or business".

In 1944, the Commissioner of Internal Revenue, in I.T. 3666, recognized generally that breeding animals were "property used in the trade or business" within the definition of Section 117 (j), and that capital gains treatment was therefore available on the sale of such animals.[22] However, he promptly thereafter initiated a series of efforts to restrict the application of the section in this area as much as possible by narrowing

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21—A raised breeding animal is subject to the allowance for depreciation, but because the animal was born on the farm it has no acquisition cost and therefore nothing to depreciate. Petitioner attempts to rationalize I.T. 3712, 1945 Cum. Bull. p. 176, later revoked, which prohibited a livestock farmer on the accrual method of accounting and using the unit livestock price method from depreciating his raised breeding animals. Brief, p. 32, fn. 23.

22—"Any livestock used for draft, breeding, or dairy purposes, irrespective of whether such live stock was raised or otherwise acquired, is property used in the trade or business, of a character which is subject to the allowance for depreciation, within the meaning of section 117(j) of the Internal Revenue Code, provided it is held for more than six months. This is equally true whether the farmer keeps his books and files his returns upon the cash receipts and disbursements basis or upon the accrual basis."

the definition of what constituted a "breeding animal" for purposes of Section 117 (j).[23] Finally, Congress in 1951 recognized the "confusion and dispute" into which the Commissioner had brought this area of the law[24], and sought to end the confusion by amending Section 117 (j) of the 1939 Code to include specifically within the definition of "property used in the trade or business", "livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes . . ." This amendment, which now appears as Section 1231 (b) (3) of the 1954 Code, was, by its terms, made applicable to taxable years beginning after 1941. The 1951 amendment to Section 117 (j) "came into being, not because of contrary case law which Congress disapproved, but because of the Commissioner's continuing reluctance to give full application of the statute to breeding stock."[25]

23—The first attempt was in 1944, where the Commissioner, in I.T. 3666, 1944 CB 270, held that animals culled from the breeding herd as feeder or slaughter animals were not entitled to capital gains treatment. The second attempt was in 1945, in I.T. 3712, 1945 CB 176, where the Commissioner set forth an abnormal-normal sales test for determining whether sales of livestock from the breeding herd were or were not entitled to capital gains treatment. The third attempt was in 1951, where the Commissioner, in Mimeograph 6660, 1951-2 CB 60 held that capital gains treatment would be given to breeding animals sold from the herd only if they had been actually used for breeding purposes for substantially their full period of usefulness. These efforts on the part of the Commissioner to restrict the capital gains treatment granted by Congress no doubt forced many taxpayers to pay taxes that they should not have paid, but as time passed the Commissioner was forced to retreat on I. T. 3666 and I. T. 3712 by the Eighth Circuit Court of Appeals in Albright v. United States, 173 F. 2d 339, and by the Fifth Circuit Court of Appeals in United States v. Bennett, 186 F. 2d 407. He was forced to retreat on Mimeograph 6660 by the 1951 Senate amendment to Section 117(j). At the time of this amendment, the Senate took note of the "new uncertainties" resulting from Mimeograph 6660. Thereupon, by Mimeograph 6676, 1952-1 CB 71, the Commissioner revoked Mimeograph 6660.

24—Senate Report No. 781, 82d. Cong. 1st Session, 1951-2, C.B. 457, 487, contained comments upon the changes proposed in Sec. 117(j) by the then pending Revenue Act of 1951. It recited the existence of "considerable confusion and dispute for several years" as to the use or sale aspects of livestock held for breeding purposes. It referred to I.T. 3666, I. T. 3712, two litigated cases, Mim. 6660, and to "new uncertainties" resulting from this last regulation. See United States v. Ekberg, supra, p. 920.

25—United States vs. Ekberg, supra, p. 923.

While the enactment by Congress of the 1951 amendment to Section 117 (j) ended the Commissioner's efforts to restrict the application of Section 117 (j) by narrowing the definition of what constituted breeding animals, the Commissioner continued his previously begun attempts to force livestock farmers to capitalize, rather than expense, the cost of feeding and raising their breeding animals.[26] Presumably his theory was that the cost of feeding, sheltering, medicating and otherwise caring for and maintaining the breeding animal during its growth period was actually equivalent to purchasing the animal, and should therefore be capitalized as the purchase price and not deducted annually as a current expense. However, this theory ran into the formidable obstacle that expenses of this nature were clearly ordinary expenses of operation and could not logically be treated as the purchase price of an animal, and the even more formidable obstacle that one of the oldest and most firmly established regulations of the Commissioner stated categorically that **the cost of feeding and raising livestock is deductible as a current expense.** This regulation, which is now Reg. 1.162-12, originated as Reg. 45, Art. 110, in the year 1921, and read as follows:

> ". . . the cost of feeding and raising livestock may be treated as an expense deduction. . ."

This same provision appears in all succeeding regulations of the Commissioner, without material change, and the Regulations today, Reg. 1.162-12, provide exactly the same thing, with only a slight change in wording:

> "The purchase of feed and other costs connected with raising livestock may be treated as expense deductions. . ."

26—This effort began early. In I.T. 3666, it was conceded that a cash method farmer could deduct these raising costs, but the position of the accrual method farmer on this point was left vague.

This regulation has become imbedded in the law as a result of having been part of the Regulations for 45 years, during which time the statute under which the regulation was promulgated has been re-enacted several times. As stated in a letter of June 2, 1952 from the Secretary of the Treasury to Senator Walter F. George, Chairman of the Senate Finance Committee:

> ". . . since the early days of the income tax, the regulations have permitted farmers to take current expense deductions for the cost of raising livestock intended for draft, breeding, or dairy purposes."[27]

The above quoted regulation is clear and explicit, in no way ambiguous. It does not say that it applies only to farmers using the cash receipts and disbursements method of accounting, and it does not say that it applies only to livestock held for sale to customers in the ordinary course of business. Clearly it is available to any one who raises livestock, regardless of his method of accounting, and clearly it applies to all livestock raised, regardless of whether the livestock are raised for breeding purposes or for sale to customers.

In view of the foregoing regulation, the Commissioner made no attempt to force a livestock farmer using the cash method of accounting to capitalize the cost of feeding and raising his breeding animals; the 45-year old regulation was an obstacle he simply could not overcome.[28]

27—R. 9.

28—As early as 1944 the Commissioner recognized that the cash method livestock farmer was entitled to expense the cost of raising his breeding animals, and that such costs would not be capitalized. See I.T. 3666, where it is stated, inter alia, that ". . in the case of the farmer operating upon the cash receipts and disbursements basis the full cost of raising or acquiring such live stock may . . [be] deducted as an expense and . . in such case, upon the sale of any such live stock, the basis for the calculation of gain or loss is zero."

However, in dealing with the livestock farmer who used the accrual method of accounting and maintained inventories, the Commissioner found language in a section of his Regulations that led him to believe that he could force a limited group of livestock farmers to capitalize the cost of feeding and raising their breeding animals, despite Reg. 1.162-12 and its predecessors. This was the group of farmers who used the accrual method of accounting and the unit-livestock-price method of valuing their inventories. The regulation thus seized upon by the Commissioner was Regulations 111, Sec. 29.22(c)-6, the predecessor of what is now Reg. 1.471-6 (f). This predecessor regulation, which was promulgated in December 1944 by Treasury Decision 5423, 1945 Cum. Bull. 70, "permitted farmers raising livestock to value inventories according to either the farm-price method or the unit-livestock-price method. . . That portion of Regs. Sec. 29.22(c)-6, as so amended in 1944, which corresponds to the present Regs. Sec. 1.471-6 (f), read as follows:

> 'A taxpayer who elects to use the unit-livestock-price method must apply it to all livestock raised, whether for sale or for breeding, draft, or dairy purposes . . .' " United States v. Ekberg, supra, p. 918, fn. 5.

The Commissioner construed the above quoted regulation as **compelling** a livestock farmer on the accrual method of accounting and using the unit livestock price method of valuing his livestock inventories to include his raised breeding animals in inventory along with his animals held for sale to customers in the ordinary course of business. This was the position taken by the Commissioner in the **Lewis** case, in the

Ekberg case, and in the cases now before this Court.[29] Petitioner has stipulated that the raised breeding animals of the Respondents in the **Wardlaw** case were **required** by the regulations to be included in inventory.[30] The **Ekberg** case stated that

> "... Regs. 1.471-6 (f) ... provides that a taxpayer who elects to use the unit-livestock-price method must apply it to all livestock raised including breeding animals. This means that a livestock raiser who uses this method cannot segregate his raised breeding herd and treat it as though it were a capital asset subject to depreciation ..."[31]

Reg. 1.471-6 (f), and its predecessor, as thus construed by the Commissioner, required the accrual method farmer using the unit-livestock-price method of valuing his inventory to include his raised breeders in inventory along with his livestock held for sale to customers in the ordinary course of business. Thus, raised breeding animals would be put into inventory at the close of the year of birth at a standard unit price roughly equal to the farmer's actual cost of raising the animal to that age. At the end of the next year, this same animal would appear in closing inventory at a higher figure, roughly equal to the actual cost of raising the animal during its second year. The end of the third year would see a further increase in the inventory figure. This process of putting raised breeding animals in inventory at the close of the year of birth, and increasing the inventory value of the animal at the close of each year thereafter, until maturity, of course created ordinary income for the farmer each

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29—As we shall see, Petitioner now admits that this position was erroneous and that actually Reg. 1.471-6(f) does **not** require that a livestock farmer using the unit-livestock-price method of valuing his inventory must include his raised breeding animals in inventory.

30—R. 67, Par. 5.

31—United States v Ekberg, supra, p. 917, fn. 5.

year, thereby taxing the full inventory value of the animal, and consequently its entire raising cost, as ordinary income. When the animal reached maturity, its inventory value would be at a peak. Generally, the breeding animal would be kept during his useful life as a breeder and thereafter sold. The sale price of sheep and goats would rarely exceed the value at which the animal last appeared in inventory.[32] Thus the Commissioner, by taxing the initial inventory value of the raised breeding animal as ordinary income, and taxing each subsequent year's increment in inventory value as ordinary income, succeeded in taxing the bulk of the increase in the raised breeder's value as ordinary income, rather than as capital gain. Raising costs were thus completely capitalized, rather than permitted as a current expense deduction.[33] The Commissioner then allowed the livestock farmer to use the last inventory value as basis on the sale of the raised breeding animal; however, this merely prevented the taxpayer from being taxed twice on the same increase in value, once as ordinary income and then as capital gain, since the full inventory value of the animal had already been included in his taxable income and taxed at ordinary income rates!

As indicated above, from the very beginning the Commissioner recognized that, in view of Reg. 1.162-12, there was no way he could deny to the cash method farmer the right to deduct as current expenses the cost of feeding and raising his breeding animals and force him to capitalize these expenses. He recognized that Reg. 1.162-12 had acquired the force

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32—As for cattle, sale price generally exceeded inventory, but the margin varied greatly and depended largely on the unit price used and the strength of the market.

33—Petitioner has admitted that the net effect of putting raised breeders in inventory was to capitalize raising costs. Stip. 8 and 9, 25, R. 67-68, 72-73.

and effect of law, and he realized that only by a change in the statute law itself could the regulation be overturned. Accordingly, in 1952 the Commissioner attempted to get the Senate to pass legislation which would deny raising costs of breeding animals as a current expense deduction, and require that same be capitalized. When the Senate refused to adopt any such legislation, the Commissioner gave up as to the cash method farmer. This left the accrual method farmer using the unit-livestock-price method of valuing his inventory as the sole remaining victim on whom the Commissioner continued to vent his displeasure with the statute extending capital gains treatment to livestock held for breeding purposes.

As we have seen, the net effect of forcing the accrual method livestock farmer using the unit-livestock-price method of valuation to put his raised breeders in inventory was to force him to capitalize his raising costs. Petitioner admits that this is true.[34] This attempted circumvention of Reg. 1.162-12 is not supportable, for the following reasons:

(1) The Commissioner's own 45-year old Regulation 1.162-12, which Petitioner admits has attained the force and effect of law, flatly provides that any livestock farmer is entitled to deduct his raising costs as a current expense; obviously if you force him to put his raised breeding animals in inventory you are neutralizing the deduction now by creating artificial ordinary income, and you are not allowing the deduction later as an offset against ordinary income but only as an offset against capital gain. This is a clever, but, it is submitted, an invalid attempt to deny the accrual method farmer using the unit-livestock-price method of valuation his fundamental right to deduct his raising costs **as a current expense.**

34—See footnote 33, supra.

(2) There can be no logic or reason behind telling a cash method farmer that the cost of feeding and raising his breeding animals constitutes a deductible current expense, and at the same time telling an accrual method farmer using the unit-livestock-price method of valuation that the cost of feeding and raising **his** breeding animals is **not** a deductible current expense but must be capitalized! On the very face of it, and apart from it being grossly prejudicial to the accrual method farmer, this simply does not make sense. If the cost of feeding and raising breeding animals is a current expense for the cash method farmer, it must be a current expense for the accrual method farmer. The two methods differ as to **when** an item is expensed, but not as to **whether!**

(3) Finally, there is the fundamental fact that paying out money annually to feed, shelter, medicate, and otherwise care for and sustain a farm animal is clearly an expense of current operations, normal and necessary, whether the animal is being held for breeding purposes or for sale, whether the animal is growing or not growing, and by no reasonable stretch of the imagination can these costs be equated to purchasing an animal from an outsider.

II.

The taxpayers in the Wardlaw case

(1) Did not have a "meaningful choice", under the doctrine of the Ekberg case, when they selected the accrual method of accounting many years prior to 1944, and

(2) Did not have any choice at all as to the method of valuing livestock inventory they would use, being forced by the Regulations to use the unit-livestock-price method,

and are therefore not bound by their

selection of the accrual method of accounting, or their compelled use of the unit-livestock-price method of valuing their livestock inventories, either to include their raised breeding animals in inventory or to capitalize the cost of raising such animals.

The Commissioner's practice of construing Reg. 1.471-6 (f) to mean that accrual method farmers using the unit-livestock-price method of valuation **must** include their raised breeding animals in inventory along with their animals held for sale to customers in the ordinary course of business, first came to the attention of the courts in the **Lewis** case, decided in 1958. There the Circuit Court of Appeals stated that it found nothing in the 1951 amendment to Section 117 (j) indicating a congressional design to limit the extent of capital gains treatment to be accorded livestock farmers selling animals from a breeding herd simply because of their previously having selected the unit-livestock-price method of valuing their inventories.[35] In the **Lewis** case, the taxpayer began business in 1939, and at that time had his one and only opportunity to choose between the accrual method of accounting and the cash method. Furthermore, because the taxpayer in the **Lewis** case had, prior to 1944, apparently pursued a constant unit price method of valuing his inventories, and had filed returns on that basis, he was **compelled,** by virtue of Regs. 111, Sec. 29.22 (c)-6, as amended by Treasury Decision 5423, to use the unit-livestock-price method after 1944.[36] Therefore, under the "meaningful choice" doc-

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35—Scofield v. Lewis, supra, at p. 132.

36—In December of 1944, by Treasury Decision 5423, Cumulative Bulletin 1945, page 70, Reg. 111, Sec. 29.22 (c)-6 was amended to permit farmers raising livestock to value their livestock inventories according to either the farm-price method or the unit-livestock-price method, the closing paragraph of this amendment stating that

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trine of the **Ekberg** case, as hereinafter discussed, the taxpayer in the **Lewis** case did not have a "meaningful choice" when he selected his method of accounting, because it was not until I.T. 3666 was published in 1944 that it was clearly recognized that capital gains treatment was available for the disposition of breeding cattle. I.T. 3666 recognized that breeding animals would qualify as "property used in the trade or business" under Section 117 (j), but it also noted a great difference in the extent of capital gains treatment that would be accorded cash method farmers and accrual method farmers who put their raised breeders in inventory. Hence it was vitally important that a farmer should not elect the accrual method of accounting and put his raised breeders in inventory, or adopt a method of valuing his inventory that would **require** him to do so, such as the unit-livestock-price method!

In the **Ekberg** case, decided in 1961, the taxpayer began his livestock business **after** 1944, and at that time selected the accrual method of accounting and the unit-livestock-price method of valuing his livestock inventory. Later, the taxpayer sought to remove his raised breeding cattle from inventory. The Commissioner objected, stating that "this taxpayer has freely selected and uses the accrual-inventory method of accounting and the unit-livestock-price method of evaluation,"[37] and that he was therefore bound by his

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"A livestock farmer who has, for taxable years beginning prior to January 1, 1944, adopted a constant unit price method of valuing livestock inventories and filed returns on that basis **will be considered as having elected the 'unit-livestock-price method'.**" (Emphasis added.)

Thus any livestock farmer who was in business prior to 1944, and who used the accrual method of accounting and a constant unit-price method of valuing livestock inventory, such as the farmers in the **Wardlaw** case, was **compelled** by the above-quoted language of Reg. 111, Sec. 29.22(c)-6, as amended by Treasury Decision 5423, **to use the unit-livestock-price method of valuation whether he wanted to or not!**

37—United States v. Ekberg, supra, p. 916.

election. The Circuit Court of Appeals, however, recognizing the tremendous difference in the treatment accorded by the Commissioner to livestock farmers using the cash method of accounting and livestock farmers using the accrual method of accounting and the unit-livestock-price method of inventory valuation,[38] probed into the question of whether the "election" of the taxpayer was (1) a blind choice between the cash method and the accrual method, without the taxpayer having any reason to know that one method would give full capital gains treatment while the other would not, or was (2) a "meaningful choice", with knowledge of the extremely disparate tax consequences flowing from each method of accounting. The Court also inquired as to whether the taxpayer's selection of the unit-livestock-price method had been, by the same test, a "meaningful choice". The Court then found that I.T. 3666, issued in 1944, clearly recognized that capital gains treatment was available for the disposition of breeding cattle.[39]

38—"The taxpayer has kept his books and records on the accrual basis of accounting; because of this, he has been required by the applicable regulations . . to use inventories to determine gross income. He has also employed the unit-livestock-price method of valuing his livestock inventory; because of this, he has been required by the applicable regulations, Sec. 1.471-6(f), to apply that method to his breeding livestock as well as to his cattle held for sale. Specifically, he has assigned in the taxable year of birth, a full unit price of $70 to each new heifer. . .

"This addition to inventory at the unit price of each new heifer in the breeding herd results in an increase in the taxpayer's ordinary income for the taxable year and in a reduction in the gain, if any, upon the animal's subsequent disposition. If, in contrast, the taxpayer could carry each breeding animal at a zero basis, as would be the case if he used the cash receipts and disbursements method, its birth would not create ordinary income, its net disposition price would constitute gain in its entirety rather than in part, and, with all other qualifying factors satisfied, that gain would be afforded capital gains treatment rather than ordinary income treatment. The taxpayer presumably, as is the case for each of the three taxable years here, would then enjoy a lower income tax." United States v. Ekberg, supra, p. 915.

39—Ekberg v. United States, supra, p. 917, fn. 5. With the disparate results, as between cash method farmers and accrual method farmers who put their raised breeders in inventory, as noted supra, fn. 38.

The Court then concluded as follows:

> "As we have noted, I.T. 3666, which was issued in 1944, **and thus well before the taxpayer's selection of the accrual-inventory method and of the unit-livestock-price evaluation system,** clearly recognized that capital gains treatment was available for the disposition of breeding cattle if all other necessary elements were satisfied. We conclude that the taxpayer at the inception of his business was not denied the opportunity of making a considered and meaningful choice of available options."

In other words, the Court reasoned that, after 1944, when I.T. 3666 was issued, a livestock farmer should have known that if he used the cash method of accounting he could deduct his raising costs as current expenses and pay capital gains taxes on the amount received for his raised breeding animal, whereas if he elected the accrual method of accounting and the unit-livestock-price method of valuing his inventory he would be required to include his raised breeding animals in inventory, thereby losing the right to deduct the cost of raising his breeders as a current expense and instead being compelled to capitalize these costs; the Court then concluded that if the farmer, **after 1944,** selected the accrual method of accounting and the unit-livestock-price evaluation system, he should be bound by his election. But if he made his selection prior to 1944, and that was the only selection he had, then he should not be bound by his choice, because, coming before 1944, it would not be "meaningful." This has become known as the doctrine of "meaningful choice".

In the **Wardlaw** case, the livestock farmers were in essentially the same position as the taxpayer in the **Lewis** case; but were not in the same position as the

taxpayer in the **Ekberg** case, where the taxpayer selected his accounting method and his method of valuing his inventories subsequent to 1944, which made his choice a "meaningful choice". In the **Wardlaw** case, the farmers **began business long before 1944,** and it was when they began business that they had their one and only opportunity to chose an accounting method. Since this opportunity occurred prior to 1944, it was not a "meaningful choice", and hence not binding on them as a matter of election. Furthermore, the farmers in the **Wardlaw** case selected their method of valuing inventories when they began business, which as noted was long before 1944. Hence, that election was not a "meaningful choice" either. They had no subsequent opportunity either to select a different accounting method or to change their method of valuing their inventories. Ordinarily, they could have switched to the farm-price-method of valuing their inventories in 1944, when the Regulations first offered this method and the unit-livestock-price method to all livestock farmers; but the regulation that offered the farm-price method and the unit-livestock-price method to all farmers in 1944 contained the following requirement:

> "A livestock raiser who has, for taxable years beginning prior to January 1, 1944, adopted a constant unit price method of valuing livestock inventories and filed returns on that basis **will be considered as having elected the 'unit-live-stock-price method'.**" (Emphasis added.)

Because of this sentence in the Regulations, the farmers in the Wardlaw case had no choice of valuation method whatsoever in 1944, but were compelled to "elect" the unit-livestock-price method. Under the Commissioner's then interpretation of the Regulations, farmers who elected to use the unit-livestock-price

method were required to include their raised breeding animals in inventory. As we have seen, this inclusion of breeders in inventory created ordinary income in the year of inclusion and in each year thereafter until the breeder reached maturity, and this ordinary income completely offset the deduction for raising costs granted by Reg. 1.162-12, and its predecessors, and the net result of this, as Petitioner admits, was to require that raising costs be capitalized rather than deducted. This was a satisfactory result for the Commissioner, but harsh treatment for livestock farmers in the **Wardlaw** case category. **To say that they elected the unit-livestock-price method of valuation is obviously false. They did not elect it, but were forced to adopt it.**

Petitioner's position on the "meaningful choice" doctrine of the **Ekberg** case has been one of considerable vacillation. In its argument in the courts below in the **Catto** case, now before this Court, it pressed the contention that the taxpayers in that case did have a meaningful choice, and therefore were bound by their election. In its argument in the **Wardlaw** case in the courts below, **Petitioner has acknowledged that the Wardlaw farmers did not have a meaningful choice,** stipulating that the taxpayers began their livestock business, and made their one and only selection of accounting method, long before 1944, and in 1944 were **compelled** to use the unit-livestock-price method of valuing their inventories because they had, in years prior to 1944, used a constant unit method of valuing their inventories. R. p.67, par. 5. Despite this recognition that the farmers in the **Wardlaw** case did not have a meaningful choice, the Petitioner nevertheless insists that the farmers in the Wardlaw case have no right to correct the situation by taking their raised breeding animals out of inventory.

Again, in opposing the petition for a writ of certiori in the **Ekberg** case, the Government stressed the importance of "meaningful choice", pointing out that the taxpayer in the **Lewis** case did not have a meaningful choice whereas the taxpayer in the **Ekberg** case did. Even in Petitioner's Brief in Support of his Petition for certiori in the instant cases, Petitioner recognized this vital distinction of "meaningful choice".[40]

Despite Petitioner's past concern for the "meaningful choice" doctrine, Petitioner now "disagrees" with that doctrine.[41]

It did not make sense to the court in the **Lewis** case, it did not make sense to the court in the **Ekberg** case, and it does not make sense now, to hold that a livestock farmer should be denied the full capital gains treatment offered explicitly to him by Congress simply because in years prior to such offer, or long before the farmers accounting method or his inventory valuation method had any significance at all from the standpoint of capital gains treatment for breeding animals, the farmer had selected the accrual method of accounting and a constant unit price method of valuing his livestock inventories.[42]

40—See Brief for the Respondent in Opposition, in the **Ekberg** case, at p. 7, relevant portions being quoted at p. 8 of the Brief for the Respondent in Opposition, in the **Wardlaw** case.

41—However, the Petitioner wants to eat his cake and have it too: While rejecting the doctrine of "meaningful choice" on page 19 of his Brief, on pages 24-25, fn. 15, he points out that the taxpayers in the **Catto** case had a meaningful choice: "It is evident from the record that the respondents in **Catto** did have an opportunity to change from the accrual to the cash method of accounting after it had become clear that breeding cattle were subject to capital gain treatment." Thus, when the doctrine seems to serve his purposes, the Petitioner espouses it, but when it confronts him with an obstacle, as in the **Wardlaw** case, he disagrees with it. B. pp. 18-19.

42—The Ekberg case recognized this principal of equity when it required, in order to bind a farmer to a prior election, that the prior election be a meaningful or knowledgeable choice, and not just a blind chance. This principal was recognized with approval

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Petitioner has never denied the fact that the taxpayers in the **Wardlaw** case **did not** have a meaningful choice, either as to accounting method or as to method of valuing their livestock inventories. However, Petitioner has apparently sought to obscure this fatal weakness in his case against the farmer-taxpayers in the **Wardlaw** case by consolidating the **Wardlaw** case with the **Catto** case, in which case the Petitioner has argued repeatedly that the taxpayers **did** have a meaningful choice. It is respectfully submitted that this Court should not, and will not, permit the alleged facts of one case to obscure the facts of another case, even though the two cases have been joined for purposes of bringing the overall problem to the attention of this Court.

III

Petitioner no longer contends, as he did in the District Court and the Court of Appeals, below, that, under Reg. 1.471-6 (f) and its predecessor, an accrual method farmer using the unit-livestock-price method of valuing his inventories must include his raised breeding animals in inventory. He now says that the Regulations do not require this. His new contention is that livestock farmers who have chosen the unit-livestock-price method of valuing their inventory must capitalize the costs of feeding and raising their breed-

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in Little v. Commissioner, 294 F.(2) at p. 665 where the Court said that "the recent decision in United States v. Ekberg provides support for our conclusion." Banks v. Commissioner, 322 F(2) 530, although actually not involving the problem now before this Court, and Gibbs v. Commissioner, 33 TC 37, involving a taxpayer who began business in 1949 and was therefore, under the doctrine of the Ekberg case, bound by his election, recognized and followed the equitable doctrine of the Ekberg case. Neither Visintainer v. United States, 301 F. (2) 312, affirming per curiam 191 F. Supp. 425, nor Tee Bar Ranch Co. v. United States, 63-2 U.S.T.C. par. 9663, involved raised breeding animals. Of all these cases, only the Lewis and Ekberg cases have considered in depth the problem now before this Court.

ing animals, even though they do not include such animals in their inventory. This new contention not only directly violates the Commissioner's 45-year old Reg. 1.162-12, but is illogical and discriminatory.

With the filing of his brief in this Court, Petitioner has materially altered his position on what was regarded as the critical point in the cases now before this Court as they were argued in the District Court and the Court of Appeals, below. In the **Wardlaw** case, the revenue agents in the field required the taxpayer-farmers to put their raised breeding animals in inventory. Petitioner's position throughout this litigation, until now, has been that Reg. 1.471-6 (f) required that this be done.[43] Moreover, Petitioner has stipulated that the taxpayers in the **Wardlaw** case were required by the Regulations to carry all their livestock, including their raised breeding herd, on an inventory basis.[44] Furthermore, both **Ekberg** and **Lewis** were decided on the premise that Reg. 1.471-6(f) required an accrual method farmer using the unit-livestock price method to include his raised breeding animals in inventory.[45]

43—"The Commissioner has required, however, that farmers using the unit-livestock-price method apply that same valuation approach to their raised breeding animals including their breeding herd, **by maintaining them in their inventory accounts.** Regulation Sec. 1.471-6 (f) . ." (Emphasis added). See Brief for the United States, in the Court of Appeals below, at p. 13.

44—The farmers in the **Wardlaw** case were "required by the Regulations next below mentioned to and did carry all their livestock raised and held for sale on the market, and also their raised . . and purchased livestock constituting their breeding herd and held by them for breeding purposes, on an inventory basis . . ." R. p. 67, Par. 5.

45—The Ekberg case stated categorically that ". . Regs. 1.471-6(f) . . . provides that a taxpayer who elects to use the unit-livestock-price method must apply it to all livestock raised including breeding animals. This means that a livestock raiser who uses this method cannot segregate his raised breeding herd and treat it as though it were a capital asset subject to depreciation . . ." United States v. Ekberg, supra, p. 917, fn. 5.

Having argued the case in the courts below on the ground that the accrual method farmer using the unit-livestock-price method of valuing his inventories was required by Reg. 1.471-6 (f) to include his raised breeding animals in inventory along with his livestock held for sale to customers in the ordinary course of business, and that the **Lewis** case was wrong when it stated that the regulation requiring such inclusion was invalid as to the taxpayer before that court, **the Petitioner now takes the position that "the Regulations do not require" a livestock farmer "to include raised breeders in inventory . . ."** Brief, p. 30, footnote 19.

Respondent does not profess to know what has motivated Petitioner to shift his position, and alter his argument, in this manner. Perhaps he has had an "eleventh-hour" conversion to the belief that if Reg. 1.471-6(f) is construed to mean that livestock farmers using the unit-livestock-price method of valuation are required to put their raised breeding animals in inventory along with livestock held for sale to customers then such regulation would be invalid as against **all** livestock farmers, not just those who had no "meaningful choice" in the matter.

Whatever the reason for this shift from his position in the courts below, the Petitioner now advances a new construction of Reg. 1.471-6 (f). His new contention seems to be that while "the Regulations do not require"[46] the inclusion of raised breeding animals in inventory, Reg. 1.471-6 (f) does require that farmers "who have chosen the unit-livestock-price method of valuing their inventory of beef cattle", i.e., livestock held for sale to customers in the ordinary course of business, must capitalize the cost of feeding and rais-

46—Brief, p. 30, fn. 19.

ing their breeders.[47] Presumably, this means that the farmer using the unit-livestock-price method of valuing his animals held for sale must capitalize the raising costs of his breeders even though he has not chosen to put the breeders in inventory.[48] Since, as we have seen, and as Petitioner admits, the net effect of requiring breeders to be included in inventory is to force a capitalization of the costs of feeding and raising the breeders, then it is obvious that requiring the capitalization of the raising costs of breeders even

47—Brief, Pages 30, 32. In stating this new construction of Reg. 1.471-6 (f), Petitioner for some reason avoids saying that the farmer must "capitalize" his raising costs; instead he says that the costs ought to be "deferred rather than deducted". Brief, p. 32. It may be that he feels that this sounds better because it leaves the clear suggestion that although these costs can't be deducted as a current expense right now (even though Reg. 1.162-12 provides that they can) they are simply being deferred, and will be allowed later as a deductible expense. This, of course, is far from the truth, and Petitioner knows it. These raising costs, if allowed to be deferred in this manner, will never be allowed as an expense deduction! They will only be allowed as basis in computing gain when the breeding animal is sold. This is the same thing as telling a business man that his business expenses will not be allowed as deductible business expenses, but not to worry because they will be allowed as basis when he sells his business!

48—If, as may be the case, in view of his having retreated from the view that a farmer using the unit-livestock-price method for valuing his animals held for sale must include his raised breeders in inventory, the Petitioner's new construction of Reg. 1.471-6 (f) does not mean to require the capitalization of raised breeding animals which the farmer has chosen not to put in his inventory, but means that the farmer who elects this method for his livestock held for sale must capitalize the raising costs of his breeding animals only if he has included these animals in inventory, then the substance of the Petitioner's new position is that if a farmer elects to use the unit-livestock-price method for his animals held for sale he is not required to include his breeders in inventory (which inclusion, we have seen and the Petitioner has admitted, would be the equivalent of requiring the capitalization of the raising costs of the breeding animals) or to capitalize the raising costs of his breeders unless he elected to put them in inventory. This would give the farmer an option at the time he elects to use the unit-livestock-price method, either to put his breeders in inventory or to leave them out; and if he left them out he would not have to capitalize their raising costs. Respondents would not object to this interpretation of Reg. 1.471-6 (f), because the option would make the regulation fair. However, even under this interpretation of the Petitioner's new construction of Reg. 1.471-6 (f), the Respondents in the **Wardlaw** case would not be controlled by this Regulation because they had no such option when they were forced to adopt the unit-livestock-price method in 1944 because at that time the Regulation was construed to mean that farmers using the method **must** include their raised breeding animals in inventory.

though they have not been included in inventory is exactly the same thing as requiring that the breeders be included in inventory! Therefore, while this new statement of his position by the Petitioner may be considered clever semantics, actually it only serves to emphasize the fact that Petitioner is violating his own long-standing Reg. 1.162-12. His argument in the District Court and the Court of Appeals below, to the effect that raised breeders must be included in inventory, violated Reg. 1.162-12 because the net effect of the inclusion was to require a capitalization of raising costs. His new argument violates Reg. 1.162-12 directly by saying that raising costs of all breeders, whether in or out of inventory, must be capitalized, and therefore the violation is more apparent.[49]

49—It is difficult to be really sure what the Petitioner's contentions are in this case. He began by saying that farmers who elected the unit-livestock-price method were required by Reg. 1.471-6 (f) to include their raised breeding animals in inventory. He now says this is not required, but that the regulation in question does require a farmer electing the unit-livestock method to capitalize the costs of raising his breeding animals. Br. pp. 30, 32. He does not say whether this includes raised breeding animals which have not been included in inventory. Presumably it does. Finally, he says that ". . . the legislative history and statutory reenactment which prevent the Treasury from amending the Regulations relating to cash method ranchers also give the effect of law to the Regulations requiring accrual method ranchers to capitalize the costs of raising breeding animals." This is a thoroughly misleading statement for the following reasons:

(1) His first reference to "the Regulations" in the above-quoted sentence is undoubtedly Regulation 1.162-12, and he leaves the impression that it relates to cash method ranchers alone. This is not true, because it clearly relates to accrual method ranchers as well as cash method ranchers. See letter from the Secretary of the Treasury, above-quoted, which states that the right to deduct raising costs as a current expense is a right which has been extended to all livestock farmers since the early days of the income tax.

(2) In his second reference to "the Regulations", he is probably referring to Reg. 1.471-6 (f), or he is referring to some other section of the Regulations. But in either event he is leaving a false impression when he states that "the Regulations" require "accrual method ranchers" to capitalize the costs of raising breeding animals. The reason is that there is no provision in any of the Commissioner's regulations which contains the general requirement that "accrual method ranchers" must capitalize the costs of raising breeding animals. The nearest thing to any such requirement is the regulation which has caused the controversy now before this Court, namely, Reg. 1.471-6 (f), and that regula-

(Continued on next Page)

IV

It is not necessary for the farmers in the Wardlaw case to obtain the consent of the Commissioner in order to remove their raised breeding animals from inventory and to continue to deduct the cost of raising these breeding animals as a current expense.

The Petitioner contends that the farmers in the **Wardlaw** case, regardless of any other factors, must obtain his consent before they can remove their raised breeding animals from inventory. This argument was advanced in the **Lewis** case, but the **Lewis** case found the removal was not a change of accrual method, and furthermore, that consent was not necessary because the Regulation requiring the inclusion was invalid as to the taxpayer before that court since he had not been afforded a "timely option" when he had to select his accounting and inventory valuation method.[50]

This same argument was also advanced in the **Ekberg** case, where the court, in effect, said that the argument was sound as to the taxpayer there before the court because such taxpayer had had a meaningful choice when he selected the accrual method of accounting and the unit-livestock-price method of inventory valuation, and was therefore bound by his election.

In both of the instant cases now before this court, **Wardlaw** and **Catto,** the Court of Appeals found, as it did in the **Lewis** case, that withdrawal of these animals from inventory, because the animals had been put there in the first place by reason of a Regulation that

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tion is confined to accrual method ranchers **who elect to use the unit-livestock-price method.**

This sort of loose treatment of the controversy now before this Court is not designed to persuade, but merely misleads.

50—United States v. Ekberg, supra, p. 9.

was invalid as to the taxpayers before the court, did not require the consent of the Commissioner.

The taxpayers in the **Wardlaw** case, when the new Regulations in 1944 for the first time offered livestock farmers the farm-price method of inventory valuation and the unit-livestock-price method, were required by the Regulations to "elect" the unit-livestock-price method, which in turn required the inclusion of raised breeders in inventory, according to the Commissioner's then construction of that Regulation. Save for being thus locked in to the unit-livestock-price method, the taxpayers in the **Wardlaw** case could have selected the farm-price method, which does not require the inclusion of raised breeders in inventory. **Therefore, the raised breeders belonging to the farmers in the Wardlaw case were in inventory in the years now under consideration only because the Commissioner construed Reg. 1.471-6 (f) to require it.** The Commissioner now says that this Regulation does not require such inclusion, but he makes the incredible argument that even though, during the years in question, the taxpayers put their raised breeders in inventory because he told them they had to, under Reg. 1.471-6 (f), and even though they could have left the animals out of inventory, beginning in 1944, but for being locked in to the unit-livestock-price method by the Regulations, nevertheless they cannot now remove their raised breeding animals from inventory without his consent, and this he will not give.

While the Commissioner has a general right to require a taxpayer to obtain his consent before there is a material change of accounting method, this right cannot be exercised in an arbitrary manner, nor be used to override or circumvent a statute. In the instant case, the Commissioner occupies the insupportable position of having told the taxpayers in this case, by

his construction of Reg. 1.471-6 (f), that they had to include their raised breeding animals in inventory; and then when they did so he seeks to make them keep their raised breeding animals there on the ground that they have not obtained his consent to remove them. This is an obviously arbitrary refusal, and a complete distortion of the use of the authority to require consent.

Moreover, the taxpayers in the **Wardlaw** case have every right to follow the specific prescription of Reg. 1.162-12, which Petitioner admits has attained the effect of law, and take a current expense deduction for the cost of feeding and raising their breeding animals. This cannot be done unless the animals are removed from inventory, because the inclusion of the animals in inventory negatives or neutralizes any deduction of raising costs. It is submitted that consent of the Commissioner is not required in order for a taxpayer to adjust his bookkeeping in order to follow the explicit language of Reg. 1.162-12.[51]

51—If the Commissioner can, by the exercise of his general authority to require taxpayers to obtain his consent before materially changing their accounting method, require that the farmers in the **Wardlaw** case not deduct their raising costs as a current expense, but instead capitalize them, despite the fact that the right to deduct is expressly given by a regulation which has attained the effect of law, this would seem to constitute the grossest sort of administrative abuse by the Commissioner. For instance, suppose Congress passed a law which said expressly that accrual method farmers may deduct the raising costs of their breeders and may pay capital gains taxes only on the proceeds from the sale of these raised breeders. This would be a permissive statute, not providing what the farmer **must** do, but providing what he **may** do. If the Commissioner did not like this legislation, he could simply say to the farmers that, in order to deduct your raising costs and take capital gain on the proceeds of the sale of your raised breeders, you would be changing your accounting method by changing your previous handling of this item of raising costs, and your previous handling of the item of proceeds from the sale of your raised breeders; and that therefore you need my consent, and I refuse to give it. Surely no court would approve this sort of procedure by the Commissioner, whereby the Commissioner puts himself above the law and above the will of Congress. In the instant **Wardlaw** case we have exactly that situation, except that the provision giving the right to the livestock farmer to deduct his raising costs as a current

Finally, a general provision giving the Commissioner the right to require consent before a material change of accounting method must always yield before specific statutes, such as Reg. 1.162-12. See **North Carolina Granite Corporation v. Commissioner,** 43 T.C. 149, at p. 168, and cases there cited.[52]

V

Principal Fallacies In Petitioner's Three Arguments

Petitioner's first argument is that

> "The dichotomy between cash and accrual method ranchers is supported by sound accounting practices and by history, and has been approved by Congress." Brief. p.8.

No doubt the dichotomy to which the Petitioner refers is the dichotomy, or difference, in treatment of the cash method farmer and the accrual method farmer on the subject of r a i s e d breeding animals.[53]

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expense is given by a 45-year old Regulation, which through process of statutory re-enactment has achieved the effect of law. It is therefore submitted that there is no justification whatever for saying that the consent of the Commissioner is necessary to allow these farmers to remove their raised animals from inventory and thereby be enabled to deduct the cost of raising their breeders as a current expense rather than be forced to capitalize such cost by including their raised animals in inventory.

52—When the farmers in this case sought to remove their raised breeding animals from inventory they did not seek the consent of the Commissioner, because the Commissioner, as has been stipulated, was not even considering applications from livestock raisers to withdraw raised breeding animals from inventory (which he considered to be a change of accounting method) until after the 1954 Regulations were promulgated, which was by Treasury Decision 6366 on February 19, 1959, Stip. 31, R. 77.

53—The Respondents have never questioned the fact that there is a difference in timing, as between the accrual method farmer and the cash method farmer, as to all income and disbursements.

If so, it is submitted that sound accounting practices do not support the Commissioner when he permits a livestock farmer using the **cash method** of accounting to deduct the cost of feeding and raising his breeding animals as current expenses, and then turns around and tells the **accrual method** farmer that these very same raising costs must be capitalized.[54] Under sound accounting practices, the difference between the cash method and the accrual method is one of timing only, and this does not mean the same item is to be expensed under one method and capitalized under the other!

It is further submitted that Reg. 1.162-12, and its predecessors, have explicitly provided, for over 45 years, that **livestock farmers are entitled to deduct the cost of feeding and raising breeding animals as a current expense.** This regulation applies to all livestock farmers, as the Secretary of the Treasury said in 1952,[55] and not just to farmers using the cash method of accounting. To deny this current expense deduction to accrual method farmers by requiring them to capitalize, rather than expense, their raising costs, is a flat rejection of the rights created by this long-accepted regulation. This regulation has assumed the force and effect of law by repeated re-enactment of the statute under which it was promulgated, and the regulation has remained unchanged for 21 years be-

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54—Even the Secretary of the Treasury has said that this difference in treatment, as between the cash method farmer and the accrual method farmer "discriminates heavily" against the accrual method farmer. See letter to the chairman of the Senate Finance Committee, R. p. 9 at p. 12.

55—". . . since the early days of the income tax, the regulations have permitted farmers to take current expense deductions for the cost of raising livestock intended for . . breeding . . purposes." Letter from the Secretary of the Treasury to the Chairman of the Senate Finance Committee, cited supra.

fore and 23 years since the enactment of Section 117 (j), for 22 years since I.T.3666 was issued, and for 14 years since the enactment of Section 1231 of the Revenue Act of 1951. It is significant that Petitioner failed to explain, or even cite, Reg. 1.162-12 in his Brief or in his Reply Brief, before the Court of Appeals below; but when the existence of the regulation was repeatedly pressed upon him by Respondents, Petitioner finally acknowledged that the regulation existed but asserted that an accrual method farmer was not entitled to expense his raising costs under the regulation because the Commissioner had given the word "may" in the regulation[56] "an administratively circumscribed compass" so as to deny the expense deduction to accrual method farmers, although as a matter of "administrative expediency" the cash method farmer was allowed to deduct these same raising costs as a current expense. See Reply Brief of the United States to the Supplemental Brief for Appellee-Cross Appellants, in the Court of Appeals, W. H. Wardlaw, et al, page 4.

It is submitted that giving the word "may" "an administratively circumscribed compass" is scarcely an acceptable reason for denying to accrual method livestock farmers the right expressly granted by Reg. 1.162-12 to **all** livestock farmers. The fact is that Reg. 1.162-12 is so clear and explicit on the point that the costs of feeding and raising livestock constitute "current expense deductions" that there is no way to justify a denial of the expense deduction to **any** livestock farmer.

56—"The purchase of feed and other costs connected with raising livestock may be treated as expense deductions . ." Reg. 1.162-12.

B. Petitioner's second argument is that

> "There is no merit to Respondents' claim that they have a right to use a hybrid accounting system because they elected the accrual method before the advent of capital gains on breeding animals." Brief, page 18.

Respondents are now using the accrual method of accounting and they expect to continue to use it. They are not seeking to switch to the cash method of accounting, as Petitioner admits.[57] Nor are Respondents asking to use a hybrid accounting method. For the reasons set forth hereinabove, they simply ask that (1) they not be required to keep their raised breeding animals in inventory where, Petitioner now admits, there is no obligation to keep them, and (2) that they be permitted to continue taking the cost of feeding and raising their breeding animals as a current expense (as permitted by Reg.1.162-12) and not be required to capitalize these expenses.

Petitioner takes the position that the farmers in the **Wardlaw** case cannot remove their raised breeding animals from inventory because they elected the accrual method of accounting and the unit-livestock-price method of inventory valuation. Of course, there is nothing in the accrual method of accounting or in the Regulations covering the unit-livestock-price method of inventory valuation that says a farmer must include his raised breeding animals in his inventory. This the Petitioner admits. Probably the Petitioner would now agree that the farmers in the **Wardlaw** case are entitled to remove their raised breeding animals from inventory. But immediately this is done the Petitioner would claim that because these farmers chose the unit-livestock-price method of inventory valu-

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57—"... respondents do not . . seek to switch from the accrual to the cash method of accounting." Brief, p. 23.

ation, these animals should be set off separately from inventory and be given a basis equal to the cost of feeding and raising these animals, in other words, that their raising costs must be capitalized. This then is what the parties are now contending about before this Court. Simply stated, the issue is: Must a livestock farmer who has **chosen** the unit-livestock-price method of inventory valuation capitalize the cost of raising his breeding animals, whether he has put them in inventory or not?

The answer of the Respondents in the **Wardlaw** case to this question is as follows:

(1) **The Respondents in the Wardlaw case did not elect or choose the unit-livestock-price method. It was forced upon them by the Regulations.** As pointed out in detail hereinabove, the unit-livestock-price method was first offered to farmers in 1944 by the amendment to the Regulations. This amendment made two valuation methods available: the farm-price method and the unit-livestock-price method. However, this same amendment also stated that a farmer who, prior to 1944, used a constant unit price method of valuing inventory, "will be considered as having elected" the unit-livestock-price method. The farmers in the Wardlaw case fell into this category, and hence were locked into the unit-livestock-price method as soon as it was offered. Obviously they did not voluntarily elect the method.[57A]

(2) Under the **Ekberg** meaningful choice doctrine, farmers will be bound by their choice of the accrual method and the unit-livestock-price method of valu-

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57A—If the farmers in **Wardlaw** had not thus been locked in to the unit-livestock-price method by the Regulation, they could have elected the farm-price-method, left their breeders out of inventory, and thus avoided all of the hardship of this litigation.

ing inventories only if, when they made the choice, it was "meaningful". The thrust of the **Ekberg** case is simply that if you are going to bind a taxpayer because of a prior election or choice, then you must find that the taxpayer knew, or should have known, what the available choices were and the tax consequences which would flow from each. The **Ekberg** case concluded that where a taxpayer had to make his choice prior to 1944, then such a choice could not be "meaningful" because it was only by I.T. 3666, published in 1944, that the Commissioner of Internal Revenue recognized that capital gains treatment under Section 117 (j) was available on the sale of breeding animals.[58]

(3) Respondents decided many years ago, long before 1944, at the time they adopted the accrual method of accounting, that they would use a constant unit price method in valuing their inventories. There was no regulation providing for this, it was simply an informal practice commonly followed by livestock farmers. But this method was not the unit-livestock-price method of 1944, and subsequent years,

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58—By the same token, the decision of the farmers in the **Wardlaw** case to put their raised breeding animals in inventory was not a "meaningful choice". This choice was made many years prior to 1944, just as their selection of the accrual method of accounting was made many years prior to 1944. Therefore, this election to put their raised breeders in inventory was no more a "meaningful choice" of available alternatives than was their selection of the accrual method of accounting. During these early years, inclusion of raised breeding animals in inventory brought precisely the same tax consequences as leaving them out, and this fact remained true all down through the years until Congress saw fit to extend capital gains treatment to raised breeding animals. It would be thoroughly unjust to say that because the farmer put his raised breeding animals in inventory in 1913, or at any time prior to 1944, when it made absolutely no difference taxwise whether he did so or not, he ought now to be forbidden to discontinnue such inclusion and forbidden to remove his raised breeders from inventory, when the law has changed and it has become extremely important tax-wise, as to whether or not you carry your raised breeding animals in inventory.

which Petitioner, in the courts below, said required the inclusion of raised breeding animals in inventory, and now says requires the farmer to capitalize the cost of feeding and raising his breeding animals, whether he has chosen to include them in inventory or not. The constant price method elected by the Respondents many years prior to 1944 was obviously not the same as the unit-livestock-price method as construed by the Petitioner today. Consequently, it would be absurd to argue that the election of the constant-unit price method amounted to an election of the unit-livestock-price method.

C. Petitioner's third and last argument is that

> "The unit-livestock-price variant of the accrual method of accounting is an acceptable method of computing the amount of raising costs which are to be deferred pending sale of the animals." Br., page 25.

Since this supposed argument assumes the answer to the issues now before this Court, there is no argument to answer.

In his brief, Petitioner has argued that when an animal is born on the farm, and the farmer decides to keep the animal as an addition to his breeding herd, that paying the cost of raising that animal to maturity is the same as a manufacturer paying the price of purchasing or constructing a piece of business machinery. This analogy is more deceptive than helpful. The cost of greasing, oiling, servicing, and otherwise caring for a piece of machinery is obviously a deductible current expense, and will not be capitalized as part of the cost of purchasing or building the machine. In the same way, the cost of feeding, sheltering, medicating, and otherwise caring for the raised breeding animal is also a deductible current expense. The

Commissioner himself decided this to be true, as far back as the early days of the income tax[59]. The difference between the two cases is that the raised breeding animal is growing during this period after he is born, and will be worth more at maturity, three or four years later, than at birth. On the other hand, the machine will presumably be worth less three or four years later. Of course, if the machine is rare, or especially well built, or if prices are rising, it might well be that the machine could be sold later for more than it cost. If so, the increase in value would be capital gain, and meanwhile the owner of the machine has taken depreciation as a current deduction, and has taken a current deduction for greasing, oiling, servicing, and otherwise caring for the machine. But the Commissioner apparently feels that the farmer should not be able to deduct his costs of feeding, sheltering, medicating and otherwise caring for the breeding animal, and receive capital gain when the animal is sold after its useful life. Therefore, the Commissioner fights the accrual method farmer using the unit-livestock-price method for valuing his inventories, although he has given up as to the cash method farmer and apparently would not fight against an accrual method farmer using the farm price-method of valuing his inventory.

Frankly, it is difficult to understand exactly why the Commissioner has made such a crusade of this matter of raised breeding animals. There are other areas in tax law where essentially the same situation exists, and the Commissioner has shown no reluctance in permitting current expense deductions and subsequent capital gain treatment. For instance, in the case of growing fruit trees the cost of caring for and main-

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59—When the original version of Reg. 1.162-12 was adopted.

taining the trees during their growth and development period is permitted as a current expense deduction, and when the trees, or orchard, are sold the gain is capital gain. The Commissioner has never challenged this deduction, and yet the only difference between the orchard farmer and the farmer raising breeding animals is that there is more likelihood that the farmer will sell his breeding animals than that the farmer will sell his orchard.[60] This is a point of difference, but it is certainly not ground for distinguishing the two cases. Another situation where the deduction of current expenses is permitted, even though such expenses directly build up the value of a capital asset, is the very common situation where goodwill (an intangible property) is an important element in an incorporated business, and is cultivated and developed and increased in value as the result of spending which is deducted as a current business expense; thereafter the corporation is sold, and the seller receives capital gain on the sale of the business, including the good-will which has been increased in value by virtue of the deducted expenses. Still another case would be where a taxpayer buys a motel, and then through advertising and promotion, and other deductible business expenses, builds up the popularity of the motel; as a result, the motel is now worth, and can be sold for, considerably more than when it was built, the increased value, taxable at capital gain rates, being directly traceable to the funds spent, and currently deducted, on advertising, promotion, etc. Both of these latter cases, like the orchard case, differ from the raised breeding animal situation in that there is more likelihood that the raised animal will be sold than it is that the business or motel will be sold. But again, this is not ground

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60—Actually, peach orchards are frequently sold, and the gain is capital gain.

for distinguishing the cases, because the principle involved is the same.

Despite the foregoing the Commissioner continues to fight the raised breeding animal situation. This reluctance by the Commissioner to extend the full benefit of Section 1231 to breeding stock was noted first in the **Ekberg** case.[61]

CONCLUSIONS

Respondents submit that they have every right to remove their raised breeding animals from inventory, because by requiring Respondents to keep them there the Commissioner, as the Petitioner admits, is forcing them to capitalize the cost of feeding and raising these animals when the Commissioner's own long-standing Reg. 1.162-12, which Petitioner admits has attained the force and effect of law, provides that such costs are deductible as current expenses.

If, after removing these breeding animals from inventory, Respondents are entitled to receive capital gains treatment on the subsequent sale thereof, that is because Congress has seen fit to give them this privilege, and it is not within the province of the Commissioner to take it away, directly or indirectly.

Despite the foregoing, Petitioner now contends that if a farmer has elected, or "chosen", B. p. 32, the unit-livestock-price method of valuing his animals held for sale, he must capitalize the cost of raising his breeding animals, whether he has chosen to carry these breeding animals in inventory or not. On this ground, Petitioner would deny Respondents' claim to remove these breeding animals from inventory. This contention is specious (1) because the Respondents in the **Wardlaw** case nev-

61—United States v. Ekberg, supra,, p. 923.

er elected the unit-livestock-price method, but were forced by the Regulations to adopt same, and (2) because **any** Regulation that forces the farmer to capitalize the costs of feeding and raising his breeding animals is invalid because it violates Reg.1.162-12, which through the process of statutory re-enactment has attained the force and effect of law, and (3) because it is fundamentally unsound to contend that the cost of feeding, sheltering, medicating and otherwise caring for and raising an animal, whether he is in his growth period or not, is other than an ordinary and necessary expense of the farm operation. If there were any substance to the contention that these raising costs are equivalent to the cost of acquiring or building a capital asset, then why hasn't the Commissioner long ago told the cash method farmer that he must capitalize such costs? Surely the Commissioner knows that the acquisition cost of a capital asset must be capitalized by a cash method taxpayer as well as an accrual method taxpayer. The Regulations have for 45 years stated that the cost of raising breeding animals is a current expense deduction, and therefore cannot also constitute capital costs; there is simply no way the Commissioner can take a different position on this without new legislation.[62]

62—The relief asked by the Respondents in the **Wardlaw** case and granted by the courts below, is designed simply to put them in the position they would have been in had they not been required to include their raised breeding animals in inventory or to capitalize their raising costs. Clearly these farmers are entitled to a refund of the taxes they had to pay by virtue of the Commissioner requiring them to keep their raised breeding animals in inventory when they sought to remove them. The years for which relief is asked are 1957, 1958 and 1959. The only way to accomplish this relief is to remove all raised breeding animals from inventory at the close of the earliest year open under the Statute of Limitations, which year is 1957. This means that the ordinary income of these farmers will be reduced by an amount exactly equal to the ordinary income which was improperly created by the inclusion of their raised breeding animals in inventory. This relief will only be for raised breeding animals

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It is respectfully submitted that the judgment of the Circuit Court of Appeals with respect to raised breeding animals should be affirmed.

Respectfully submitted:

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born in 1957 or later, or born before 1957 but still in inventory at the close of that year. Because of the Statute of Limitations, no relief whatever is available for the 13 years (1942-1956) of ordinary income tax unlawfully extracted on account of animals born, raised and sold prior to 1957.

APPENDIX A

Revenue Act of 1942, c.619, 56 Stat. 798.

§151. Real property; Involuntary conversions; etc.

(b) Gains and losses from involuntary conversion and from the sale or exchange of certain property used in the trade or business. Section 117 (relating to capital gains and losses) is amended by inserting at the end thereof the following new subsection:

"(j) Gains and losses from involuntary conversion and from the sale or exchange of certain property used in the trade or business

"(1) **Definition of property used in the trade or business.** For the purposes of this subsection, the term 'property used in the trade or business' mean property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

"(2) **General rule.** If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and

losses shall be considered as gains and losses from sales or exchange of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

"(A) In determining under this paragraph whether gains exceed losses, the gains and losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.

"(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion."

Revenue Act of 1951, c.521, 65 Stat. 452.
Sec. 324 Sales Of Livestock

Section 117(j) (1) is hereby amended by adding at the end thereof the following new sentences: "Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry." The first sentence added to section 117(j) (1) by the amendment made by this section shall be applicable with respect to taxable years beginning after December 31, 1941, except that the extension of the holding period from 6 to 12 months shall be applicable only with respect to taxable years beginning after December 31, 1950. The second sentence added to section 117(j) (1) by the amendment made by this section shall be applicable only with respect to taxable years beginning after December 31, 1950.

Reg. 111, Sec. 29.22(a)-7. Gross income of farmers—A farmer reporting on the basis of receipts and disbursements (in which no inventory to determine profits is used) shall include in his gross income for the taxable year (1) the amount of cash or the value of merchandise or other property received during the taxable year from the sale of livestock and produce which were raised during the taxable year or prior years, (2) the profits from the sale of any live stock or other items which were purchased, and (3) gross income from all other sources. The profit from the sale of live stock or other items which were purchased after February 28, 1913, is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale of animals purchased as draft or work animals or solely for breeding or dairy purposes and not for resale, the profit shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation theretofore allowed (but not less than the amount allowable) in respect of such property as a deduction in computing net income.

In the case of a farmer reporting on the accrual basis (in which an inventory is used to determine profits), his gross profits are ascertained by adding to the inventory value of live stock and products on hand at the end of the year the amount received from the sale of live stock and products, and miscellaneous receipts for hire of teams, machinery, and the like, during the year, and deducting from this sum the inventory value of live stock and products on hand at the beginning of the year and the cost of live stock and products purchased during the year. In such cases all live stock raised or purchased for sale shall be included in the inventory at their proper valuation determined

in accordance with the method authorized and adopted for the purpose. Also live stock acquired, for draft, breeding, or dairy purposes and not for sale, may be included in the inventory, instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently by the taxpayer. In case of the sale of any live stock included in an inventory their cost must not be taken as an additional deduction in the return of income, as such deduction will be reflected in the inventory. (See section 29.22(c)-6.

REG. 111, SEC. 29.23(a)-11 Expenses of farmers. —A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc., may be deducted. The cost of feeding and raising live stock may be treated as an expense deduction, in so far as such cost represents actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. Where a farmer is engaged in producing crops which take more than a year from the time of planting to the process of gathering and disposal, expenses deducted may, with the consent of the Commissioner (see section 29.41-2), be determined upon the crop basis, and such deductions must be taken in the year in which the gross income from the crop has been realized. The cost of farm machinery, equipment, and farm buildings represents a capital investment and is not an allowable deduction as an item of expense. Amounts expended in the development of farms, orchards, and ranches prior to the time when the productive state is reached may be regarded as investments of capital. Amounts expended in purchasing

work, breeding, or dairy animals are regarded as investments of capital, and may be depreciated unless such animals are included in an inventory in accordance with section 29.22(a)-7. The purchase price of an automobile, even when wholly used in carrying on farming operations, is not deductible, but is regarded as an investment of capital. The cost of gasoline, repairs, and upkeep of an automobile if used wholly in the business of farming is deductible as an expense; if used partly for business purposes and partly for the pleasure or convenience of the taxpayer or his family, such cost may be apportioned according to the extent of the use for purposes of business and pleasure or convenience, and only the proportion of such cost justly attributable to business purposes is deductible as a necessary expense. If a farm is operated for recreation or pleasure and not on a commercial basis, and if the expenses incurred in connection with the farm are in excess of the receipts therefrom, the entire receipts from the sale of products may be ignored in rendering a return of income, and the expenses incurred, being regarded as personal expenses, will not constitute allowable deductions. (See also sections 29.22(a)-7, 29.23(e)-5 and 29.23(1)-10.)

Reg. 111, Sec. 29.22(c)-6 (As amended by T.D. 5423, Dec. 15, 1944). Inventories of livestock raisers and others farmers. * * *

Because of the difficulty of ascertaining actual cost of livestock and other farm products, farmers who render their returns upon an inventory basis may value their inventories according to the "farm-price method", and farmers raising livestock may value their inventories of animals according to either the "farm-price method" or the "unit-livestock-price method".

The "farm-price method" provides for the valua-

tion of inventories at market price less direct cost of disposition. If this method of valuing inventories is used, it must be applied to the entire inventory except as to livestock inventoried, at the taxpayer's election, under the "unit-livestock-price method". If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in section 29.41-2.

The "unit-livestock-price method" provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal within a class. A livestock raiser electing this method of valuating his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and unit prices would be as follows: calves, $15; yearlings, $22.50; two-year old, $30; mature animals, $37.50. The classification selected by the livestock raiser, and the unit prices assigned to the several classes, are subject to approval by the Commissioner upon examination of the taxpayer's return.

A taxpayer who elects to use the "unit-livestock-price method" must apply it to all livestock raised, whether for sale or for breeding, draft, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent years in the valuation of livestock inventories. No changes in the classification of

animals or unit prices will be made without the approval of the Commissioner.

A livestock raiser who uses the "unit-livestock-price method" must include in his inventory at cost any livestock purchased, except that animals purchased for breeding, dairy, or draft purposes can, at the election of the livestock raiser, be included in inventory or be treated as capital assets subject to depreciation after maturity. If the animals purchased are not mature at the time of purchase, the cost should be increased at the end of each accounting year in accordance with the established unit prices, except that no increase is to be made in the year of purchase if the animal is acquired during the last six months of that year. If the records maintained permit identification of a purchased animal, the cost of such animal will be eliminated from the closing inventory in the event of its sale or loss. Otherwise, the first-in first-out method of valuing inventories must be applied.

If a taxpayer using the "farm-price method" desires to adopt the "unit-livestock-price method" in valuing his inventories of livestock, permission for the change shall first be secured from the Commissioner as provided in section 29.41-2. However, a taxpayer who has filed returns on the basis of inventories at cost, or cost or market whichever is lower, may adopt the "unit-livestock-price method" for valuing his inventories of livestock for taxable years beginning after December 31, 1943 without formal application for permission, but the classifications and unit prices selected are subject to approval by the Commissioner upon examination of the taxpayer's return. A livestock raiser who has, for taxable years beginning prior to January 1, 1944, adopted a constant unit price method of valuing livestock inventories and filed returns on

that basis will be considered as having elected the "unit-livestock-price method".

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